

# Financial Services Authority

From the Chairman  
Howard Davies

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Congressman Richard H Baker  
Chairman, House Subcommittee on Capital Markets,  
Securities, and Government Sponsored Enterprises  
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*Dear Congressman Baker*

In my capacity as Chairman of the Financial Stability Forum working group on highly leveraged institutions (HLIs), I would like formally to draw your attention to our report, which received strong support at the meeting of the Forum in Singapore last month.

As you are aware, a strong theme in our report and recommendations is the critical importance of promoting and sustaining adjustments in the behaviour of financial firms and enhancing market discipline. The Forum supported the use of market discipline as the primary means to reduce the systemic risk posed by HLIs. However, it also agreed that more interventionist measures, such as direct regulation of hedge funds, might have to be reconsidered if the reports' recommendations to enhance market discipline were not adequately implemented.

Our report identified measures to enhance the transparency of HLIs (including large, leveraged hedge funds) as a crucial condition for the enhancement of market discipline. The working group therefore strongly supports efforts to require disclosure by large hedge funds. Specifically, paragraph 102 of the report states that:

*"The Working Group supports the objective of enhancing public disclosure and endorses efforts within the US to achieve this goal... The Working Group believes that it is important that such legislation captures all those with the capacity to have a systemic impact on financial markets. Setting a precise threshold to determine where this line should be drawn is clearly difficult, not least because of the lack of clear data on the hedge fund industry. We note that the reach of the proposed US legislation is broad and would capture most large hedge funds provided that they had US investors or counterparties. But some funds might restructure their activities to try to evade these requirements. To address this risk the Working Group calls on all jurisdictions to consider the adequacy of their own disclosure"*

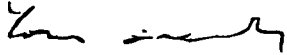
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*requirements and introduce, where necessary, appropriate changes to legislation or regulations to ensure that major hedge funds located in their jurisdictions are subject to complementary disclosure requirements. This recommendation should also apply to offshore centres, particularly those which currently host large unregulated hedge funds."*

Both the working group, and the Forum as a whole, is therefore strongly supportive of the leadership you have shown in introducing H.R. 2924. I hope that other members of Congress share your view that this is a vital measure to reduce risks to the global financial system.



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into the Banking and Commerce Committees of the US House of Representatives<sup>32</sup>. Both of these bills seek to impose disclosure requirements only on large funds which could have systemic importance. Neither measure seeks the disclosure of proprietary information<sup>33</sup>.

102. *The Working Group supports the objective of enhancing public disclosure and endorses efforts within the US to achieve this goal.* The two proposals before Congress would capture different numbers of funds. The Working Group believes that it is important that such legislation captures all those with the capacity to have a systemic impact on financial markets. Setting a precise threshold to determine where this line should be drawn is clearly difficult, not least because of the lack of clear data on the hedge fund industry. We note that the reach of the proposed US legislation is broad and would capture most large hedge funds provided that they had US investors or counterparties. But some funds might restructure their activities to try to evade these requirements. *To address this risk the Working Group calls on all jurisdictions to consider the adequacy of their own disclosure requirements and introduce, where necessary, appropriate changes to legislation or regulations to ensure that major hedge funds located in their jurisdictions are subject to complementary disclosure requirements. This recommendation should also apply to offshore centres, particularly those which currently host large unregulated hedge funds.*

103. As noted in Section IV, the build up of leverage and significant positioning in 1998 was not confined to hedge funds. In the Working Group's view, this underscores the need for enhanced disclosure of risk exposures by all material participants in financial markets. An initiative is underway to identify improvements in disclosure practices that would enhance understanding of the risks borne by all financial intermediaries, both regulated and unregulated, including HLIs. The Multidisciplinary Working Group on

<sup>32</sup> HR2924 introduced by Congressman Baker to the Banking Committee and HR3483 introduced by Congressman Markey to the Commerce Committee, respectively.

<sup>33</sup> The two pieces of legislation are, of course, subject to amendment as they are considered by Congress. However, the provisions of the bills as they have been introduced are:

- **Definition of entity to which it would be applied** – Both bills would apply to any investment vehicle which is exempted from the definition of an investment company under the Investment Company Act of 1940. HR2924 adds that it should be privately organised and not widely available to the public.
- **Threshold** – HR2924 would apply to any fund with \$3bn in capital or any group of funds with \$20bn in assets under management. HR3483 is set much lower at any group with \$1bn in assets.
- **Information required from funds** – HR2924 requires US proposals cover information on asset size, notional value of derivatives positions, leverage, summary risk measures and such other information as may be required by the Fed. HR3483 requires statements of financial condition, income, cash flows, changes in equity, models and methodologies used to assess market risk and such other information as the SEC requires.
- **Method of disclosure** – Under both bills, hedge funds would be required to file reports with regulators who would then make them publicly available, although regulators would withhold any proprietary information contained in the report.
- **Enforcement** – HR2924 states that the Fed may apply to the district court in which the hedge fund is located or, in the case of foreign funds, the District of Columbia District Court, to seek enforcement of against a hedge fund that does not comply with an order to disclose information. HR3483 does not state how the regime would be enforced.